Volume 67 | Issue 2 Article 11

February 1965

Income Tax--Depreciation in Year of Sale

Robert Willis Walker
West Virginia University College of Law

laws of the states. This line of argument might even depend somewhat on whether the function the agency was involved in was more proprietary than governmental. As an example, it seems that the Federal Emergency Relief Act would be a much more centralized governmental function than the Small Business Act. The law in this area is far from settled although some guidelines are gradually appearing. This area of law is comparatively recent in origin, and all that is certain is that this problem can only be resolved by a creative federal judiciary.

Larry Lynn Skeen

Income Tax—Depreciation In Year Of Sale

The taxpayer acquired a depreciable asset and began using a straight line depreciation method based on its estimated useful life and salvage value. He sold the asset before the end of its estimated useful life for more than its undepreciated cost. The Commissioner disallowed the usual depreciation deduction for the year of sale, asserting that in the year of retirement, the usual depreciation deduction is limited to the amount by which the undepreciated cost at the beginning of that year exceeded the amount received from the retirement. *Held,* reversed. The figure below which usual depreciation may not be taken is salvage value, an estimate made when an asset is acquired. The Commissioner may redetermine the estimated salvage value when he can show it was incorrect, but the mere event of a sale does not automatically give him the right to substitute a figure equal to the sales price as the amount below which no further depreciation may be taken. *Macabe Co.,* 42 T.C. No. 87 (1964).

An understanding of the nature and function of depreciation accounting is necessary to appreciate the problem involved in the principal case. According to generally accepted accounting principles, depreciation aims to allocate the cost or other basic value of an asset, less its estimated salvage value, over its estimated useful life. Depreciation is sharply distinguished from the concept of a decline in value. American Institute of Accountants, *Accounting Terminology Bulletin* No. 1, ¶ 56 (1953). This same principle is recognized by economists. Depreciation is not concerned with changing market values, because it is merely an allocation of so much of the original cost as is used in earning income. SAILERS, DEPRECIATION PRINCIPLES AND APPLICATIONS 47 (1922). The Supreme Court has recognized these principles in interpreting the deduction Congress has allowed for depreciation. The purpose of depreciation accounting is to further the integrity of periodic income statements by allocating the cost of an asset over its useful life. *Massey Motors Inc. v. United States*, 364 U.S. 92 (1960). The theory underlying the tax deduction for depreciation is that using up the asset amounts to its gradual sale. *United States v. Ludey*, 274 U.S. 295 (1927).

When an asset is retired the accountant treats the difference between the estimated salvage value and the actual amount realized from the sale as an extraordinary item and not as a current, ordinary income item. This is consistant with the economic theory that there are actually two types of events simultaneously affecting the value of an asset: (1) the depreciation in value because of wear and tear, and (2) the change in value because of market conditions such as supply and demand. It is very possible that at the same time events of the first type are causing the value to decrease, events of the second type may be causing the value to increase. However, the fact that these two types of events operate simultaneously and produce a net effect does not change the fact that each type is in operation and should be accounted for separately; they are not merely different aspects of the same problem. SAILERS, *op. cit. supra* at 47. The Committee on Terminology of the American Institute of Accountants emphasized the inaccuracy of considering depreciation as a method of equating book value and market value by pointing out that depreciation concerns cost. Specifically, it concerns the cost of exhaustion just as wages concern the cost of labor. American Institute of Accounts, *op. cit. supra* at ¶ 56.

The issue in the principal case involves only a part of a much broader situation arising out of the interaction of (1) the total amount of the depreciation deductions taken which reduce the highly taxed ordinary income, and (2) the amount of the receipt from the retirement of an asset that is classified as capital in nature and taxed at the low capital gain rate. The first of these is a matter of reducing the basis on which the tax is computed over a number of years. The second is a matter of classifying a receipt in the year of retirement as either capital or ordinary. INT. REV. CODE OF

1964, § 167 gives the taxpayer a deduction for depreciation on certain property for reasonable wear and tear to reduce the taxable ordinary income. Section 1001 of the CODE and subsequent sections provide that when the amount realized from the sale of an asset is greater than the undepreciated cost, the difference shall be taxed at the lower long term capital gain rate. Since undepreciated cost is merely the remainder of cost less total amount of depreciation taken, the amount of the realization that will be classified as capital rather than ordinary depends directly on the total amount of depreciation taken. Section 1231 allows capital treatment on the sale of much of the same property on which depreciation can be taken under section 167.

Therefore, in the numerous cases in which the total of the depreciation deductions has exceeded the decline in market value, the same depreciation deduction that caused a decrease in the amount of ordinary income to be taxed will also influence the classification of the receipt from the retirement in favor of classification as capital. To the extent a deduction for depreciation reduces undepreciated cost below the amount ultimately realized on the retirement of the asset, the amount of the taxpayer's ordinary income has been reduced, and the receipt from the retirement will be classified as capital gain. This is commonly referred to as depreciation recapture, a term which seems to add little clarity to the situation. In fact, this tax treatment corresponds very favorably with the economic and accounting theory mentioned above, and apparently this is what Congress intended.

The principal case is concerned with the depreciation recapture only to the extent that it occurred because of a depreciation deduction taken in the year of retirement. The following hypothetical situations illustrate this interaction and specifically raise the issue of the principal case.

The taxpayer paid 10,000 dollars for a depreciable asset. Using an estimated useful life of eight years, an estimated salvage value of 2,000 dollars, and the straight line depreciation method, he took yearly depreciation deductions of 1,000 dollars. At the end of the fourth year an unforeseen event occurred which caused the market value of the asset to increase, and the taxpayer sold the asset for 6,400 dollars. He qualified for capital gain treatment under section 1231 and will compute his gain, if any, according to section 1001 and subsequent sections. The gain will be the excess of the amount realized over the undepreciated cost.

(1) Assuming, as does the taxpayer in the principal case, that the ordinary depreciation deduction for the year of sale is limited only by the estimated salvage value of 2,000 dollars, the taxpayer can reduce the undepreciated cost from 7,000 to 6,000 dollars. Under this assumption, the full depreciation is allowed in the year of sale. The excess of the realization from the sale over the undepreciated cost is then 400 dollars. Therefore 400 dollars of the 6,400 dollars can be classified as capital gain and taxed at the low capital gain rate rather than the high ordinary income rate.

(2) Assuming, as does the Commissioner in the principal case, that the ordinary depreciation deduction for the year of sale is limited by the amount realized from the sale, the taxpayer can reduce the undepreciated cost from 7,000 dollars only to 6,400 dollars. In this event there is no excess of realization over undepreciated cost. Therefore none of the 6,400 dollars can be classified as capital gain and taxed at the low capital gain rate.

According to generally accepted accounting principles and 26 C.F.R. § 1.167(a)-1(a) (1961), the taxpayer is correct in asserting that the figure that limits the total amount of depreciation that may be taken is the estimated salvage value. However, in Rev. Rul. 62-92, 1962-1 CUM. BULL. 29, the Commissioner contends that this figure is the limit only so long as the asset is on hand and that in the year of sale the limit automatically becomes the actual realization from the sale. As can be seen from the second assumption above, this position would always prevent the ordinary deduction for the year of sale from having any effect on the classification of the realization as capital or ordinary.

The Commissioner contends that the ordinary depreciation deduction in the year of sale may be taken only to the extent the undepreciated cost at the beginning of that year exceeded the amount realized from the sale or exchange. In answer to 26 C.F.R. § 1.167(a)-1(c) (1961), which provides that the estimated salvage value shall not be changed merely because of changes in price level, the Commissioner maintains the reason for the rule fails in the year of sale. He asserts that the regulation is designed to eliminate needless controversies based on mere estimates of what depreciation should be and in the year of sale it is not necessary to rely on estimates because the actual realization is then known. To support his position the Commissioner relies on *Cohn v. United States,* 259 F.2d 371 (6th Cir. 1958), in which the court stated that a sale which shows depreciation to be out of line is more than a mere fluctuation. It is a final and definite closing of the account, and no injustice results from denying a deduction known to be fictional at the time it was taken. The Commissioner further relies on three Supreme Court cases to support his position. *Massey Motors Inc. v. United States, supra,* in which the case of *Evans v. United States* was also decided, and *Hertz Corp. v. United States,* 364 U.S. 122 (1960). In *United States v. Motorlease Corp.,* CCH 1964 STAND. FED. TAX REP. ¶ 9645 (2d Cir. 1964), the second circuit adopted the Commissioner's position and held that Congress did not design the depreciation deduction to encourage the "transmutation of ordinary income into capital gain."

The Commissioner's position does not correspond favorably with generally accepted economic and accounting theory. The idea that the depreciation deduction in the year of sale results in an undesirable "transmutation of income," that it is fictional when taken, or that it results in an undesirable recapture completely ignores the fact that depreciation deals with cost rather than value. All of these ideas ignore the fact that if market value fails to go down along with the depreciation of the cost, then a gain has been earned simply by having held the asset at a particularly favorable time.

In the principal case the Tax Court observed the Commissioner's failure to distinguish between (1) depreciation through exhaustion, and (2) changes in value due to market conditions. The court stated that the Internal Revenue Code deals separately with these problems and that the distinction is recognized in the regulations. Where depreciable property is unexpectedly disposed of substantially before the end of its useful life, the actual realization from the sale bears little or no relevance to the estimated salvage value. The court further stated that Congress intended that the cost of using an asset was to reduce the amount of income taxed at the high ordinary rate and that the Commissioner's position prevents this in the year of sale.

The judicial history of the year-of-sale depreciation problem has been inconsistent:

(1) *Wier Long Leaf Lumber Co.,* 9 T.C. 990 (1947), *acq.,*

1948-1 CUM. BULL. 3, *rev'd on other grounds,* 173 F.2d 549 (5th Cir. 1949), was decided in favor of the taxpayer. This Tax Court decision, in which the Commissioner originally acquiesed, determined that the ordinary depreciation deduction would not be disallowed merely because the price received on the retirement of the asset was more than the undepreciated cost of the asset.

(2) In *Cohn v. United States, supra,* the sixth circuit allowed the taxpayer to redetermine the useful life of the asset sold and held that where there was a redetermination of useful life, there could also be a redetermination of the estimated salvage value. The court further held that since the redetermination was being made after the asset had been sold, it was permissable, though not necessary, to use hindsight and "estimate" the salvage value to be the amount actually received from the sale. The *Cohn* case is not authority for the broad proposition that the mere event of a sale automatically entitles the Commissioner to re-estimate the useful life to be zero and estimated salvage value to be the same as the actual sale price. Merritt, *Government Briefs in Cohn Refute IRS Disallowance of Year-of-Sale Depreciation,* 20 J. TAXATION 156 (1964).

(3) *Massey Motors Inc. v. United States, supra,* and *Hertz Corp. v. United States, supra,* were decided by the Supreme Court on the same day. The Commissioner relies on these cases to support his position; however, they are factually distinguishable from his broad ruling that in the year of sale the usual depreciation deduction is limited to the amount by which the undepreciated cost at the beginning of the year exceeded the amount realized from the retirement. In each of these cases the taxpayer had failed to make any estimate for salvage value when he acquired the asset. The Supreme Court held that salvage value had to be considered as a part of the depreciation equation and that, where it must be figured after the asset is sold, hindsight may be used.

(4) In Rev. Rul. 62-92 the Commissioner, relying on the *Cohn* case, asserted his position that in the year of sale the ordinary deduction for depreciation could be taken only to the extent that the undepreciated cost exceeded the amount realized from the retirement. In effect this amounts to the substitution, in the year of sale, of the actual sales price for the estimated salvage value. In what appears to be clearly beyond the scope of the *Cohn* case the Commissioner asserts that this substitution is automatic and does not depend on there having been a mistake in the taxpayer's estimates.

(5) In *Randolph D. Rouse,* 39 T.C. 70 (1962), and *Fribourg Navigation Co.,* 21 CCH TAX CT. REP. 1533 (1962), *aff'd,* CCH 1964 STAND. FED. TAX REP. ¶ 9644, (2d Cir. 1964), the Tax Court reversed the position it had taken in *Wier Long Leaf Lumber Co., supra,* and ruled in favor of the Commissioner. In each case the taxpayer was denied his ordinary deduction for depreciation in the year of sale.

(6) *Fribourg Navigation Co., supra,* on appeal to the second circuit, was affirmed. The second circuit stated that the Commissioner's position was strongly suggested by the *Cohn* case although logically inconsistant. There was a strong dissent claiming that the majority opinion completely ignored the law. On the same day the second circuit decided *Fribourg Navigation Co., supra,* it gave a similar ruling in *Motorlease Corp., supra.*

(7) The principal case was then decided by the Tax Court in favor of the taxpayer. This represented a reversal of the position the Tax Court had taken in *Fribourg Navigation Co. supra,* which had just been affirmed by the second circuit.

(8) *Smith Leasing Co.,* 43 T.C. No. 5 (1964), is a more recent case but is distinguishable on the facts. The taxpayer failed to bear the burden of proving that his estimates were correct.

(9) *C. L. Nichols,* 43 T.C. No. 13 (1964), was recently decided in favor of the taxpayer. It seems the Tax Court has abandoned its early concurrence with the Commissioner's interpretation of the *Cohn* case. The Tax Court is now following its original position as expressed in *Wier Long Leaf Lumber Co., supra,* and reasserted in the principal case. Merritt, *New Cases Clarify Cohn Confusion on Year-of-Sale Depreciation,* 21 J. TAXATION 324 (1964).

(10) In *United States v. S & A Co.,* 338 F.2d 629 (8th Cir. 1964), the Commissioner's position was rejected and the court held that the following factors were sufficient to entitle taxpayer to his usual depreciation deduction: (a) unusual and unanticipated sale of depreciable asset during its life, (b) reasonableness of taxpayer's acquisition estimates of useful life and salvage value, and (c) the claimed depreciation would have been allowed for the sale year had the sale not taken place.

With the Tax Court returning to its original position, it appears only the Commissioner and the second circuit look with favor on

West Virginia Law Review, Vol. 67, Iss. 2 [1965], Art. 11

Rev. Rul. 62-92. However, the number of appeals pending indicates that the law on this point is not settled. Merritt, *op. cit. supra.* Congressional enactment of the Int. Rev. Code of 1962, §§ 1245, 1250, has limited the problem considerably. These sections require the taxpayer to apply the high ordinary tax rate to certain gains to the extent depreciation recapture is involved. These sections look to the much broader problem of the interaction caused by any deduction for depreciation without regard for the year in which it was taken. However, they fail to completely dispose of the issue in the year of sale because (1) they concern only certain property and (2) section 1250 operates only as to a part of the recapture. Therefore, the need for dispositive legislation or a Supreme Court pronouncement remains.

Robert Willis Walker

Procedure—Imputability of Attorney's Negligence to Client Under West Virginia Rules of Civil Procedure

Appellee was injured by a car driven by an employee of appellant. Two days before the statute of limitations would have barred his claim, appellee filed suit. About nine months later the complaint was dismissed, after notice to his then counsel, for failure to prosecute. Two years later the appellee, by new counsel, moved to reinstate the suit on the ground that his former counsel had been beset with personal problems which involved the serious illness of his wife and the recent death of his parents. Appellee was assured from time to time by his former counsel that the case was proceeding and that settlement would be made soon. Appellee learned that his case had been dismissed for failure to prosecute only by checking personally with the court clerk. The trial court granted the motion to reinstate the suit and appellant appealed. *Held,* affirmed. The trial court did not abuse its discretion in reinstating the action under Rule 60(b)(6) of the Federal Rules of Civil Procedure which allows the court to vacate judgments for reasons justifying relief from the operation of such judgments. The motion was made within a reasonable time and the appellee, a person unfamiliar with court procedures, should not be penalized by the inexcusable neglect of his counsel. A dissenting judge reasoned that the motion for reinstatement had not been made within a reasonable time and